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In the Supreme Court of the United States

OCTOBER TERM, 1977

No. 76-1137

ARTHUR FULMAN, Et Al, TRUSTEES,
PETITIONERS,

v.

UNITED STATES OF AMERICA,
RESPONDENT.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

REPLY BRIEF ON BEHALF OF PETITIONER

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This Reply Brief is being filed to rebut (1) the Government's characterization of the purpose of the personal holding company tax and (2) the Government's unsupportable conclusion that Treas. Reg. 1.562-1(a) is justified by legislative history.

I. The Government Distorts the Purpose of the Personal Holding Company and Accumulated Earnings Taxes.

In constructing its justification of Treas. Reg. §1.562-1(a), the Government has exhibited a serious misconception of the role and purpose of the personal holding company tax. It thus sees tax avoidance where none exists, turns logically related principles into inconsistencies and defends a rule which is inconsistent with the real purpose of the statute.

As Petitioner has shown in its brief, the object of the personal holding company tax, and not incidentally, the accumulated earnings tax, is to insure taxation at the shareholder level of amounts equal to a corporation's net personal holding company income or accumulated taxable income. (P. Br. 8-13) The means by which this object is accomplished is the imposition of an additional tax upon corporations which will induce the distribution of *an amount equal to* net personal holding company income (or accumulated taxable income) to shareholders as dividends. By focusing upon the consequences of the personal holding company tax on the corporate entity and ignoring its consequences at the shareholder level, the Government has grossly distorted the purpose of the taxes.

Drawing its conclusions from this distorted point of view, the Government contends that under Petitioner's proposed rule, a corporation would be improperly avoiding the personal holding company tax if it retained income which had derived from passive investment sources, even though it had distributed enough property to its shareholders to result in their being taxed upon an amount equal to the corporation's net personal holding company income. (G. Br. 6, 15, 29). Although the objective of the tax would be completely satisfied if the shareholders to

whom the property were distributed included the fair market value of the property in their income and paid tax on the full amount of the company's net personal holding company income, the Government implies that a tax is being avoided if the dividends distributed cannot be directly traced to the current year's passive investment income.[1] Not only does this perspective ignore the economic realities of business life and the ebb and flow of cash, assets and profits, but it ignores both the operation of Subchapter C of the Internal Revenue Code and the fact that nothing in the law mandates a distribution of currently earned income.

The law permits, indeed, is designed to encourage a corporation to avoid the personal holding company tax or the accumulated earnings tax by distributing *an amount equal to* its net personal holding company income or accumulated taxable income. It is unimportant and irrelevant which assets are distributed or from what source the dividend distribution derives. All that is important and relevant is that the recipient shareholder be required, as a result of the distribution, to include in gross income an amount equal to the company's net personal holding company or accumulated taxable income.

Under section 316, and therefore under section 562, the source of corporate property is irrelevant to the deter-

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[1] The government apparently visualizes a personal holding company as having some special bank account into which it deposits dividend checks received and all other income realized from passive investments, and that unless the company draws on that particular account for the dividend checks distributed to its shareholders, it is not distributing the "earnings realized" from its passive investments. Actually the personal holding company might immediately reinvest all of such income in other assets, and yet be in a position to make distributions "to the extent of its undistributed personal holding company income" (section 316(b)(2)), by borrowing the needed amount, by selling non-investment assets, or by distributing any property, however acquired. It does not matter that the very dollars of income realized by the personal holding company are not traceable directly into the dividends it distributes.

mination of whether its distribution will constitute a dividend. This is so even if the corporation has not invested any of its realized earnings in the distributed property. It must be remembered that a corporation may obtain property not only through purchase, but also as a contribution to capital, in exchange for stock, in a tax-free reorganization, as an inter-corporate dividend or as the result of the divestiture of anti-trust stock. But, for purposes of section 316, these distinctions are irrelevant. Distribution of any property, regardless of how it was obtained, will be a dividend within the meaning of section 316, and thus of section 562, as long as there are "earnings and profits" or personal holding company income to satisfy the requirements of section 316(a) or 316 (b)(2). Under section 316(a) a distribution is conclusively presumed to come "out of" any earnings and profits a corporation may have. This presumption makes it impossible to earmark a particular distribution as coming "out of" some other source, such as "paid-in surplus" or "depreciation reserves" or "unrealized appreciation." See Mertens, *Law of Federal Income Taxation* (1974 revision) Section 9.27, citing *inter alia, Beretta* v. *Commissioner*, 141 F.2d 452 (5th Cir. 1944), *aff'g* 1 T.C. 86 (1942), *cert. denied*, 323 U.S. 720. Instead, if the amount of a corporation's earnings and profits equals or exceeds the amount of a distribution to shareholders, as measured under section 301, such amount will automatically be "a dividend (as defined in section 316)" which is required by section 301(c) to be included in the shareholder's gross income.[3]

[3] The close interrelationship between sections 301 and 316 is illustrated by the Regulations promulgated under section 316. Treas. Reg. §1.316-1(a)(3) contains the following example of the determination of the amount of a dividend:

> "Example. X and Y, individuals, each own one-half of the stock of Corporation A which has earnings and profits of $10,000. Corporation A distributes property having a basis of $6,000 and a fair market value of $16,000 to its shareholders, each shareholder receiving property with a basis of $3,000 and with a fair market value of $8,000 in a distribution to which section 301 applies. The amount taxable to each shareholder as a dividend under section 301(c) is $5,000."

The adjusted basis of the property distributed is thus irrelevant to the determination of the amount of the dividend under 316, even though under section 312, the corporation's earnings and profits would be reduced by the corporation's adjusted basis in the property. In fact, even the Regulations under section 312 differentiate between the adjustment to earnings and profits and the amount of a dividend. Treas. Reg. §1.312-1(c) contains the following two examples:

> "Example (1). Corporation A distributes to its sole shareholder property with a value of $10,000 and a basis of $5,000. It has $12,500 in earnings and profits. The reduction in earnings and profits by reason of such distribution is $5,000. Such is the reduction even though the amount of $10,000 is includible in the income of the shareholder (other than a corporation) as a dividend.
>
> Example (2). The facts are the same as in example (1) above except that the property has a basis of $15,000 and the earnings and profits of the corporation are $20,000. The reduction in earnings and profits is $15,000. Such is the reduction even though only the amount of $10,000 is includible in the income of the shareholder as a dividend."

Furthermore, the Government's position is flawed by a basic factual inaccuracy. A corporation's basis in its property does not necessarily equal the cost of that property (G. Br. 31), nor is it necessarily tied to the company's realized earnings (G. Br. 29). These claims made by the Government to support its "adjusted basis rule" ignore both the fact that property is acquired by corporations by means other than purchase, and that the Code permits taxpayers to make several adjustments to the cost basis of property. For example, a corporation may depreciate certain properties and may elect among several methods or rates of depreciation. If depreciable property were distributed by two corporations, each of which invested the same amount in the property, but each of which depreciated the property at a different rate, then the application of Treas. Reg. §1.562-1(a) would result in a different deduction for

each corporation even if the fair market value of both pieces of property were identical.

In focusing upon the means by which the personal holding company tax and the accumulated earnings tax operate, the Government has lost sight of their common objectives. It must be remembered that

> [T]he real objective of the tax is to create a tax at the shareholder level equal to the corporation's earnings for the year. The objective, by definition, is satisfied only if the corporation's deductions for dividends paid is equal to the dividends taxable to its shareholders. Accordingly, the objective is satisfied, not frustrated, when individual shareholders, pursuant to sections 301 and 316, report dividends equal to the fair market value of the property distributed in kind and the corporation gets a deduction in the same amount for dividends paid. The fact that the fair market value of the property is greater or less than its adjusted basis is not relevant in determining whether the objective has been satisfied. Drake, *Distributions in Kind and the Dividends Paid Deduction—Conflict in the Circuits*, 1977-1 BRIGHAM YOUNG U.L. REV. 45, 68.[3]

II. LEGISLATIVE HISTORY OFFERS NO SUPPORT FOR TREASURY REGULATION §1.562-1(a).

The Government concludes from its study of the legislative history of the 1954 Code that (a) Congress intended

[3] This article, which contains a very thorough discussion of the issue involved in this case, came to the attention of Petitioner subsequent to the filing of its main brief. In addition, two other articles dealing with the regulation at issue have been published since the Petitioner's brief was filed. They are Zuccarini, *On Appeal to the Supreme Court in Fulman: Property Distributions by Personal Holding Companies''*, 55 *Taxes* 715 (Nov. 1977), and Axelrod, *The Accumulated Earnings Tax and the Deduction for Dividends in Property – Market Value or Basis?''* 4 JOURNAL OF CORPORATE TAXATION 208 (Autumn, 1977).

to preserve the rule of section 27(d) of the 1939 Code, which permitted a corporation making a non-cash distribution a deduction equal to the *lesser* of the property's *fair market value* or *basis*, (G. Br. 22) and (b) that Treas. Reg. §1.562-1(a) perpetuates the rule of section 27(d). (G. Br. 26-7) The first conclusion is unfounded. The second is simply a factual mistatement.

The Government's interpretation of Congressional intent is based upon the following section of the Senate Committee Report discussing section 562 of the present Code:

> Subsection (a) provides that the term ''dividend'' for purposes of this part shall include, except as otherwise provided in this section, only those dividends described in section 316 (relating to definition of dividends for purposes of corporate distributions). The requirements of section 27(d), (e), (f), and (i) of existing law are contained in the definition of ''dividend'' in section 312,[4] and accordingly are not restated in section 562. S. Rep. No. 1622, 83d Cong., 2d Sess. 325 (1954).

Despite the language of the Report, the rules of section 27(d), (e), (f) and (i) simply are not stated in section 312 of the House Bill, section 316 of the Senate Bill or section 316 of the Code as adopted. To conclude, as does the Government, that this Committee Report indicates explicit Congressional intent to carry forward the provisions of section 27(d) is totally unsupportable. The Government's

[4] As has been noted by the District Court in this case (Pet. App. B, 22, n.5) as well as by numerous commentators (e.g. Drake, *supra* at 59; Axelrod, *supra* at 22-23; Zuccarini, *supra* at 716), this reference to section 312 is an obvious typographical error deriving from the renumbering of the House Bill by the Senate. This point has been so universally accepted that it was felt that it was unnecessary to reconstruct the complicated and involved historical proof of this point. However, should the Court feel it necessary, Petitioner is ready to submit a supplemental brief confined to this point.

position is counter-indicated by the time and care devoted by Congress and the committee staffs to the drafting of the 1954 Code. This was not a hastily drafted statute. It was considered over a three year period, and significant attention was paid to the problems of the corporate-shareholder relationship. Had Congress meant to include rules of section 27 in the Code, it would have done so specifically.

The more reasonable interpretation of the language in the Committee Reports, as explained by Petitioner in its brief (P. Br. 24), has been adopted by at least one commentator:

> As an alternative to the conclusion of the *Fulman* courts, one can reasonably argue that the term "requirements" in the second sentence of the statement suggests that the drafters of the reports merely intended that this sentence communicate to the reader that the functions or "requirements" previously satisfied by sections 27(d), (e), (f), and (i) of the 1939 Code are now satisfied by section 316 of the 1954 Code. In other words, the second sentence of the statement was not intended to indicate that section 316 of the 1954 Code incorporates the exact rules of section 27 of the 1939 Code, but rather that the term "dividend" as defined in section 316 of the 1954 Code, eliminates the need for the old rules. Drake, *supra* at 61.

This interpretation is not rendered less persuasive by the principles of statutory construction cited by the Government. While the rule of *United States* v. *Ryder*, 110 U.S. 729 may be a "longstanding canon of statutory construction" (G. Br. 26), it is not applicable in this case. The statute construed in *Ryder* was "taken from and [was] substantially a reproduction of" a prior statute dealing with

the same subject matter. 110 U.S. at 738. In contrast, the 1954 Code was a thorough revision of existing revenue statutes; it was not a mere consolidation of the law or a minor change in language. Congress did not, in 1954, confine itself to "substitution of plain language for awkward terms, reconciliation of conflicting laws, omission of superceded sections and consolidation of similar provisions." *Muniz* v. *Hoffman*, 422 U.S. 454, 469. With respect to section 27 of the 1939 Code, Congress did not simply make a modification in its language. The section was eliminated. Petitioner is not inferring the repeal of section 27(d) by implication.[5] (G. Br. 26). Petitioner is noting its repeal by elimination.

Furthermore, and of utmost importance, the Government has unaccountably failed to perceive the very obvious difference between the rule of old section 27(d) and Treas. Reg. §1.562-1(a). As described previously, the rule of section 27(d) provided that the dividends-paid deduction would equal the *lesser* of the fair market value or the adjusted basis of property distributed. "Yet the regulations use adjusted basis regardless of fair market value—a rule which few would argue is not considerably different from that described in section 27(d)." TAXES, *supra*, note 3 at 717.

While it is true that if a deduction is equal to the lesser of adjusted basis or fair market value, it can never exceed adjusted basis, this observation is incomplete. Under such a rule the deduction can also never exceed the property's fair market value. Thus, fair market value as well as basis serves as the upper limit for the deduction. Because

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[5] We are not dealing with the question of whether two intersecting statutes can co-exist. Thus, none of the cases cited by the government on this point, *Regional Rail Reorganization Act Cases*, 419 U.S. 102; *Mercantile National Bank* v. *Langdeau*, 371 U.S. 555; *United States* v. *Borden Co.*, 308 U.S. 188; *Amell* v. *United States*, 384 U.S. 158, are relevant.

section 27(d) defined the deduction as the *lower* of two amounts, both figures are actually an upper limit for the deduction. The rule of section 27(d) is just as similar to the rule advocated by Petitioner as it is to Treas. Reg. §1.562-1(a). The Government's claim that the rule of section 27(d), was the "very rule that is incorporated in the Commissioner's present Regulation" (G. Br. 19) is simply untenable.

Contrary to the Government's assertion, section 27(d) did *not* provide that "the dividends paid deduction for non-cash distributions should equal the corporation's basis in the distributed property." (G. Br. 33). The impression created by the Government's brief that Treas. Reg. §1.562-1(a) merely restates a long-standing "adjusted basis rule" is thus without merit, and legislative history cannot be used to support the validity of Treas. Reg. §1.562-1(a).

Finally, the Government has ignored one important feature of the legislative history that affirmatively supports Petitioner's position. This feature is discussed in Petitioner's original brief, beginning on page 13, where we point to the definition of the term "dividend" in the House draft of the bill which became the Internal Revenue Code of 1954. The successive drafts of that bill indicate affirmatively that Congress intended to make the valuation rules of section 301 applicable in determining the amount of a "dividend" as defined in section 316 of the Code, which section 562 in turn makes eligible for inclusion in the dividends paid deduction.

The Government's brief avoids any reference to the House draft of the bill and does not attempt to answer the argument based on pages 13-18 of Petitioner's brief.

Conclusion

For the reasons stated above and in its original Brief on the merits, Petitioner submits that the judgment below should be reversed.

Respectfully submitted,

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